

INTERNATIONAL SEMINAR ON THE MANAGEMENT OF RESEARCH AND DEVELOPMENT

F.F. Neubauer

Corporate Strategy Part I

Strategic Management and Profitability

— The Nature of Strategic Management

- How it evolved *(Strategic management)*
- Its building blocks *Structure & culture*
- A framework
- The earnings potential as the subject of strategic management

Corp. strategy is a plan as a
stream of important decisions

Process of strategy formation

- 1) Strategic planning
- 2) Implementation
- 3) Evaluation

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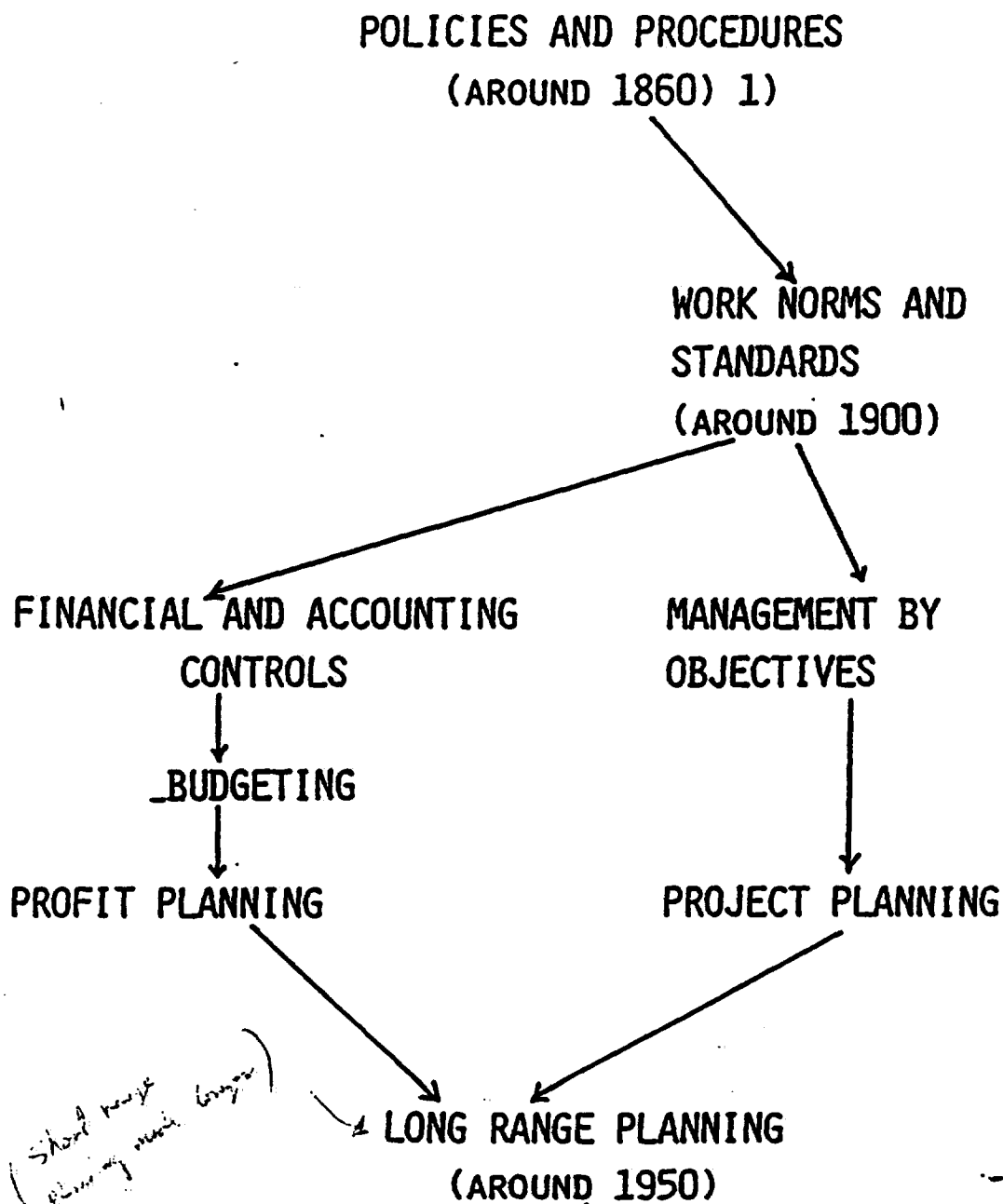
R&D1

- Which factors seem to impact on the earnings potential and profitability?

The results of some empirical research within the PIMS program

- The concept of PIMS
- The data base
- The unit of analysis
- The definition of profitability
- Selected research findings
 - factors boosting profitability
 - factors lowering profitability
- Some models

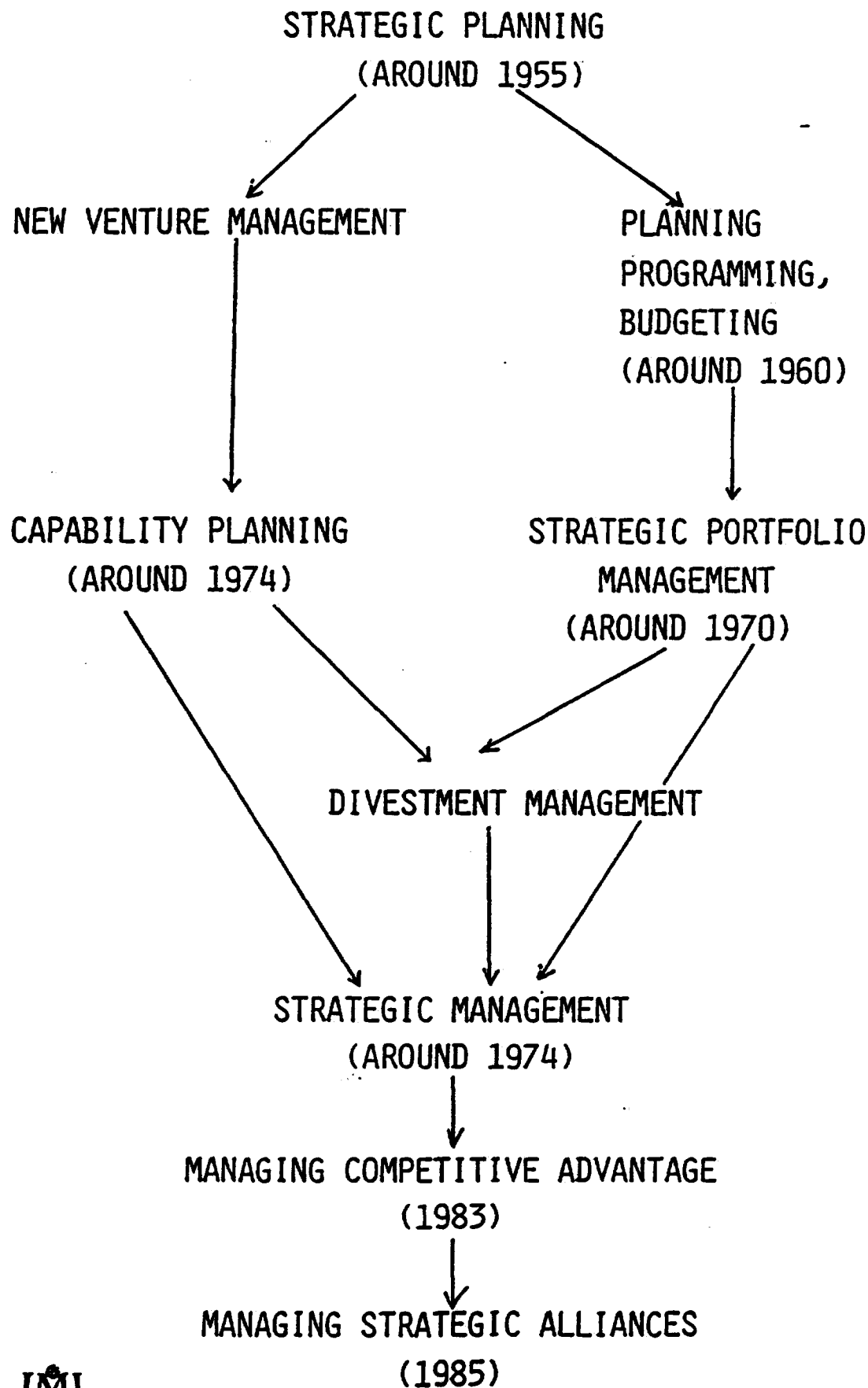
EVOLUTION OF PLANNING SYSTEMS *)



1) Dates show the approximate advent of each form

*) adapted from:

H. Igor Ansoff: "The State of Practice in Planning Systems", Sloan Management Review, Vol. 18, No. 2, winter 1977, p.7



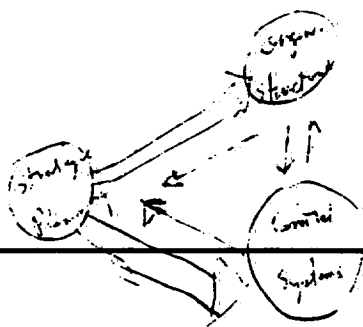
IMI

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General Electric

Criteria for forming a SBU

1. A unique business mission.
2. An integrated set of products or services; it must be a competitor in the external market.
3. There must be a clearly defined set of outside competitors.
4. The SBU ought to be located at a point in the organization at which trade-offs between different long-term decisions and between long-term and short-term decisions can be made.
5. It must be independent of other SBU's.



Strategy has to do with decisions

IPSE12

Handwritten notes at the bottom left:

if a business has a
purpose of a business
system

BBC Mannheim

Criteria for selecting a SBU

A strategic business unit must:

- be based on a homogeneous and independent product related technology,
- have strong independent competitors which offer that product group in the market,
- serve clearly identifiable markets or market segments,
- have the possibility (or feel the necessity) to establish concrete long-range objectives for its business area.

Strategic - changes taking place outside itself.
Operational - internal
consideration
communication
motivation

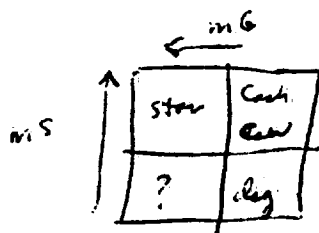
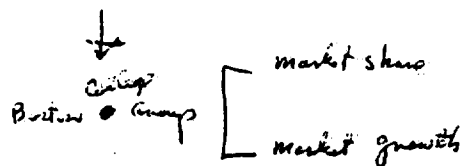
A "BUSINESS" IS AN OPERATING UNIT WHICH:

- Sells a distinct set of products or services
- To an identifiable group of customers
- In competition with a well-defined set of competitors

Strategic Planning - "Are we still going the right things?"
Action Planning - "Are we doing things right?"

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Concord Model



↓

Discretionary Quality Cycle
matrix

- mkt. Attr.
- Competitive Pos.

↓

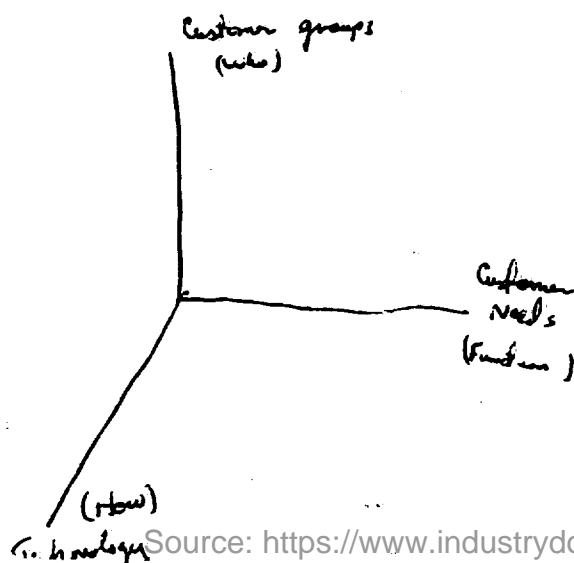
PIMS

A DIVISION SHOULD BE SUBDIVIDED INTO TWO OR MORE "BUSINESSES" IF:

- Separate strategies are feasible
- Costs and investments can be allocated plausibly
- The various components of the division have different:

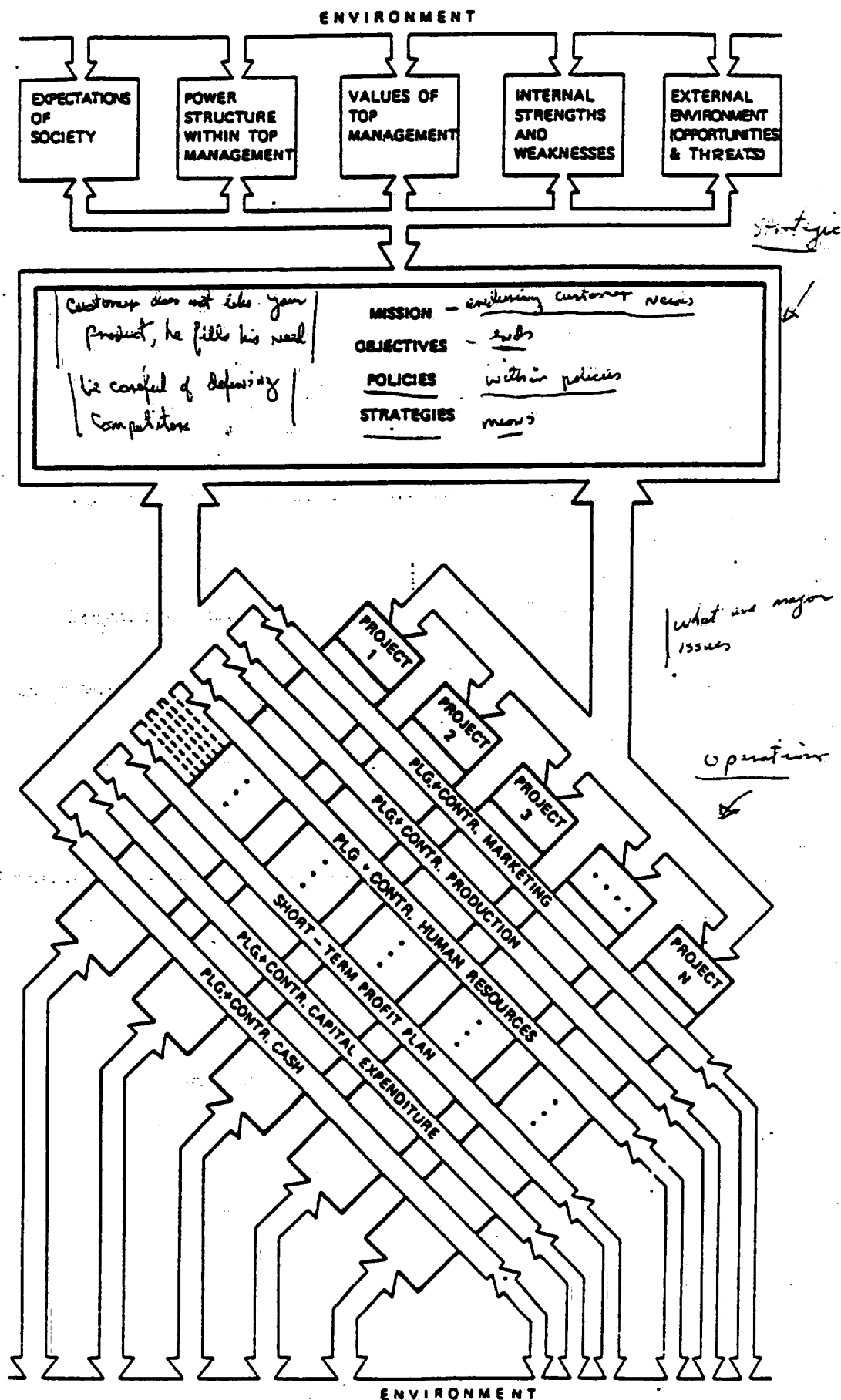
Market growth rate
Competitors
Market position
Customers

3 Dimensions



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Classical model



CONCEPTUAL PLANNING & CONTROL FRAMEWORK
(STRUCTURE)

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DICTIONARY OF KEY TERMS

PREFACE:

Clear language, if shared and used, facilitates learning and effective functioning of an organization.

In management some key expressions are used frequently, yet their meanings vary in different countries, companies and even within companies.

To avoid semantic difficulties, we propose that the following definitions be adopted for the duration of the program.

VALUES:

Personalized beliefs about what is desirable, worthwhile, justifiable.

They should mobilize and amplify an organization's energies and, therefore, need to be understood and shared.

Example: "Competition leads to greater efficiency."

MISSION:

Socio-economic purpose of a corporation. The kind of business the firm is in. Best defined in terms of satisfaction of needs, convertible into effective demands, in response to the questions:

What needs ?

Whose needs ?

Offering what value to the customer ?

The mission should be clear and expressed in terms of service or satisfaction to be rendered.

Example: "Personalized car transportation for individuals in lower income brackets. Low cost, convenience, reliability."

./...

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OBJECTIVES:

Specific aims, milestones and results of actions, defined in answer to the question :

What are we trying to achieve within
our corporate mission ?

Objectives should be measurable, feasible, time specific, and cover all areas critical to the viability of the corporation.

Example: "Increase the market share in the U.S. for product X from 13 to 20 % within 4 years."

POLICIES:

Guidelines for choice and for action. They should be consistent with values, respectful of laws and mores, and anticipate potential conflicts between objectives.

Examples: "Full ownership of foreign subsidiaries is preferred."
"We pay taxes where income is earned."

STRATEGY:

A set of major decisions and/or action programs, reflected in the allocation of resources, aiming at a selected product(service)-market posture to achieve chosen objectives, within the corporate mission.

Strategy should be explicit and serve as the basis for rules of inclusion and exclusion. It should be compatible with external opportunities and an organization's capabilities.

Example: "Shift of Latin American-rooted agricultural, distributing and shipping business to North American-based integrated chemical industry."

STRATEGIC
MANAGEMENT



Earnings
Potential

OPERATIONAL
MANAGEMENT



Profits

FINANCIAL
MANAGEMENT



Liquidity

Optimal

+

+

+

+

-

+

Tolerable

-

+

+

-

-

+

Deadly

+

+

-

young fast
growing companies

Revenue
1990
Tobacco

Analyses going out
ideas coming in

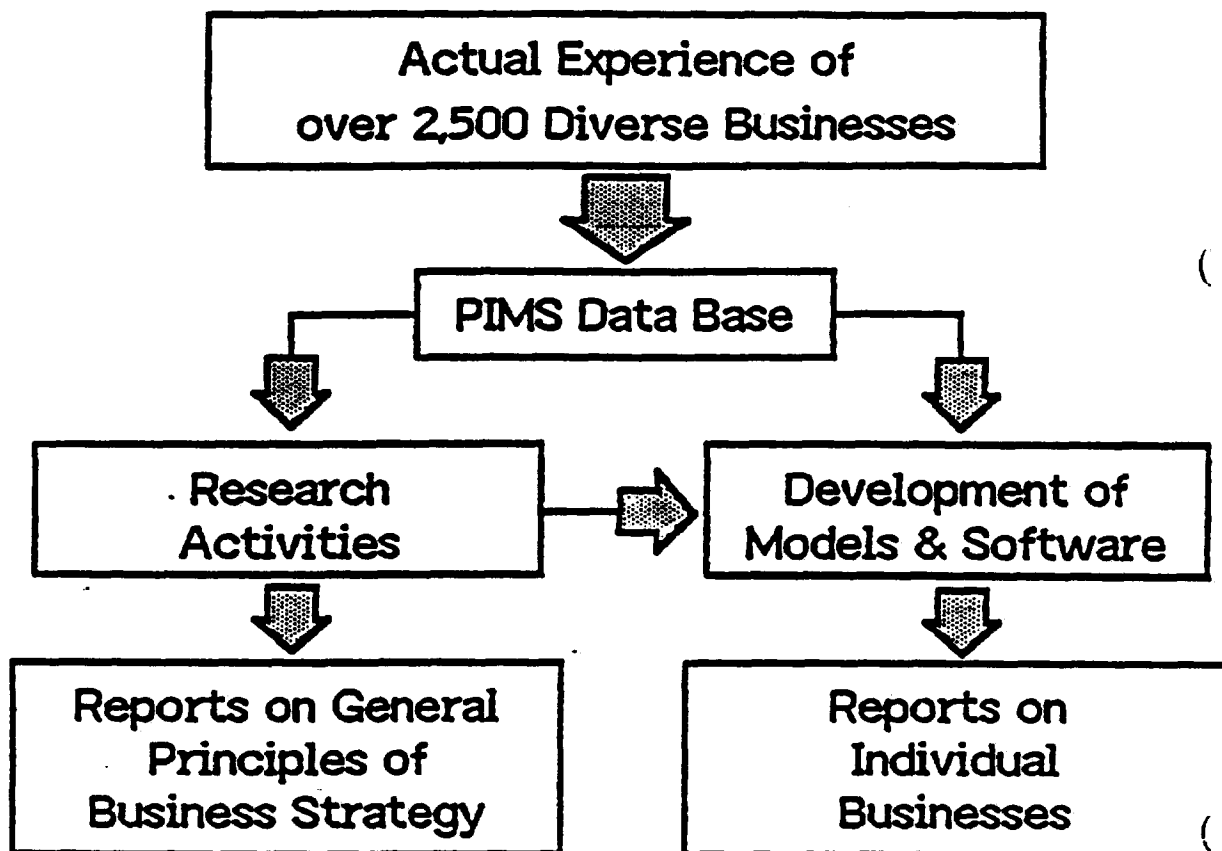
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CONCEPT OF PIMS *)

- * Pool of diverse business experience**
- * Experience interpreted as "experiment"**
- * Cross-sectional analysis**
- * Search for basic principles of strategy**
- * Apply to individual businesses,
using a simulation model**
- * Aid to business judgement**

***) PIMS = Profit Impact of
Market Strategy**

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BACKGROUND

- * Method originated at GE**
- * Developmental phase at HBS**
- * Currently organised as an autonomous non-profit institute**
- * 250 participating corporations
(size range: \$8 million -> \$15 billion)**
- * 2,500+ businesses in "experience pool"**

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COMPOSITION OF "BUSINESSES" IN THE DATA BASE

| | <u>% of Sample</u> |
|-----------------------------------|------------------------|
| Consumer products mfrs | 29 |
| Capital equipment mfrs | 19 |
| Raw materials producers | 11 |
| Components mfrs | 23 |
| Industrial supplies mfrs | 14 |
| Service & distribution businesses | 4 |
| | <hr/> 100% |

(20% outside of North America)

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INFORMATION ON EACH BUSINESS IN THE P I M S DATA BASE

(Illustrative List)

Characteristics of the Business Environment

- * Long-run growth rate of the market
- * Short-run growth rate of the market
- * Availability and use of distributors
- * Rate of inflation of selling price levels
- * Rate of inflation of cost elements
- * Number and size of intermediate customers
- * Number and size of end-users
- * Purchase frequency and magnitude

Competitive Position of the Business

- * Share of the served market
- * Share relative to largest competitors
- * Product quality relative to competitors
- * Prices relative to competitors
- * Pay scales relative to competitors
- * Marketing efforts relative to competitors
- * Rate of new product introductions

Structure of the Production Process

- * Capital intensity (degrees of automation, etc.)
- * Degree of vertical integration
- * Capacity utilisation
- * Productivity of capital equipment
- * Productivity of people
- * Inventory levels

Discretionary Budget Allocations

- * R & D budgets
- * Advertising and promotion budgets
- * Sales force expenditures

Strategic Moves

- * Patterns of change in the controllable elements above

Operating Results

- * Profitability results
- * Cash flow results
- * Growth results

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OPERATING UNIT
WHICH:**

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or services**
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have different:**
 - Market growth rate**
 - Competitors**
 - Market position**
 - Customers**

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$$\text{ROI} = \frac{\text{PRE-TAX INCOME}}{\text{AVERAGE INVESTMENT}}$$

- * "Income" is
after deduction of corporate expenses
but prior to interest charges
- * "Investment" equals
working capital plus fixed capital
(at book value)

(4-year averages used in
the following exhibits)

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MAJOR CLASSES OF PROFIT INFLUENCES

- * Industry / market environment**
- * Competitive position**
- * Differentiation from competitors**
- * Capital structure**
- * Production process**
- * Budget allocations**

**(These influences operate
on the level of a "business")**

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PIMS Program

Key Profit Influences

- 1) Investment intensity
- 2) Productivity
- + 3) Market position
- 4) Growth of served market
- + 5) Quality of the products
and/or services offered
- 6) Innovation/differentiation
- 7) Vertical integration

COMPETITIVE POSITION

KEY PROFIT DETERMINANTS

- * Market Share
- * Relative market share

(your share ÷ share of
your big 3 competitors)

| A | B |
|-------|-------|
| 20 | 20 |
| <hr/> | <hr/> |
| 5 | 20 |
| 5 | 20 |
| 5 | 20 |
| <hr/> | <hr/> |
| 15 | 60 |

$$20 \div 15 = 133\%$$

$$20 \div 60 = 33\%$$

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RELATIVE MARKET SHARE

Your share divided by the share
of your three largest competitors

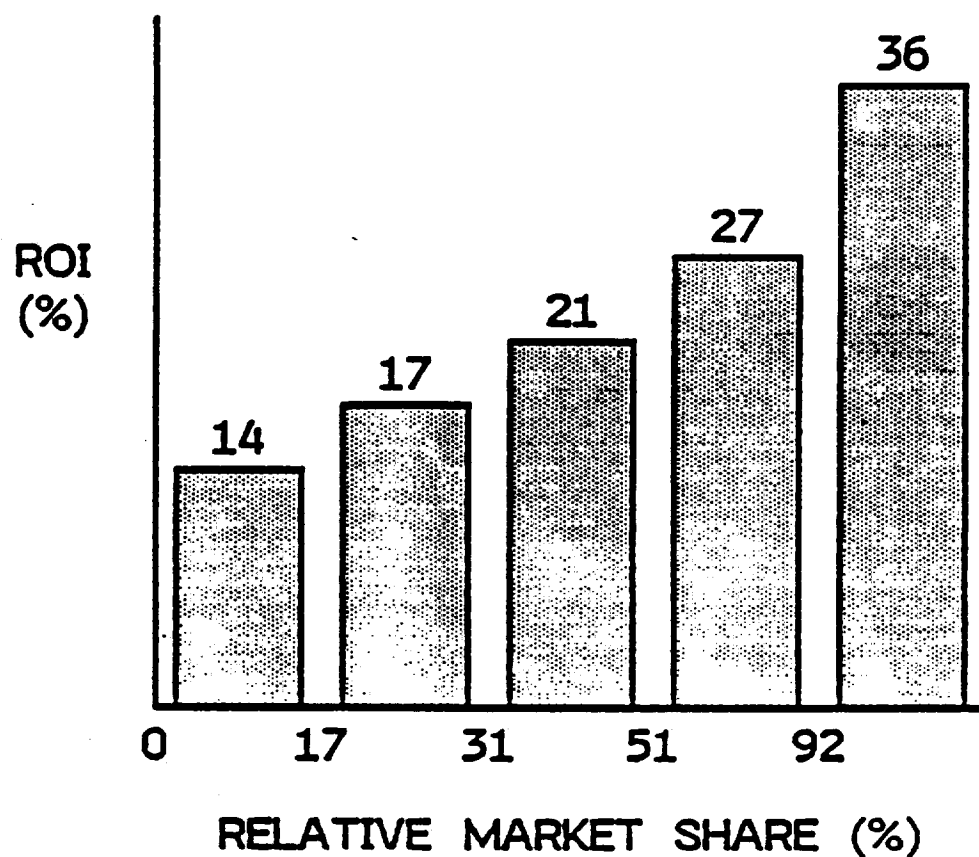
Your share = 30%

Combined share
3 largest competitors = 50%

Relative market share = 60%

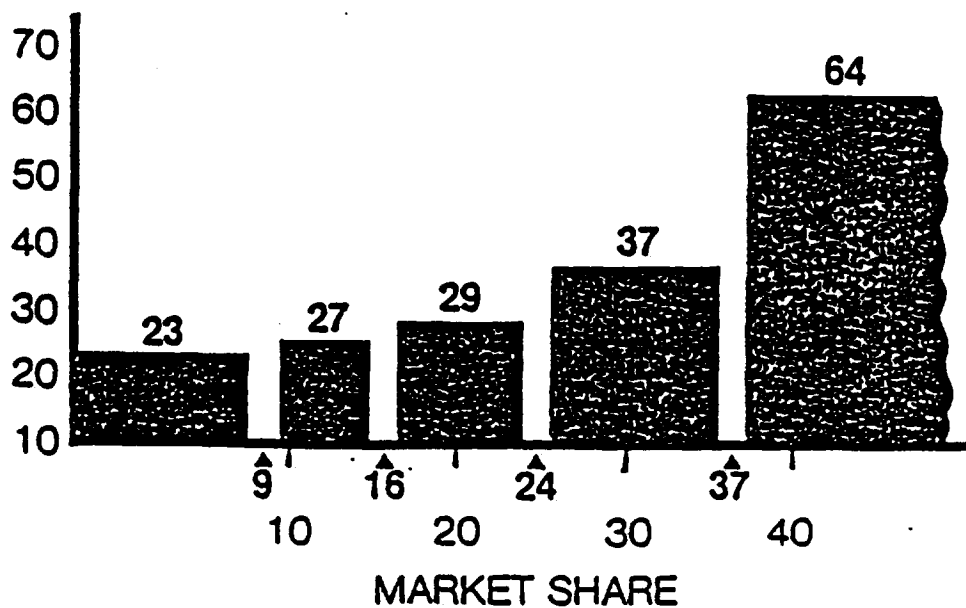
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RELATIVE MARKET SHARE IS CLOSELY RELATED TO PROFITABILITY

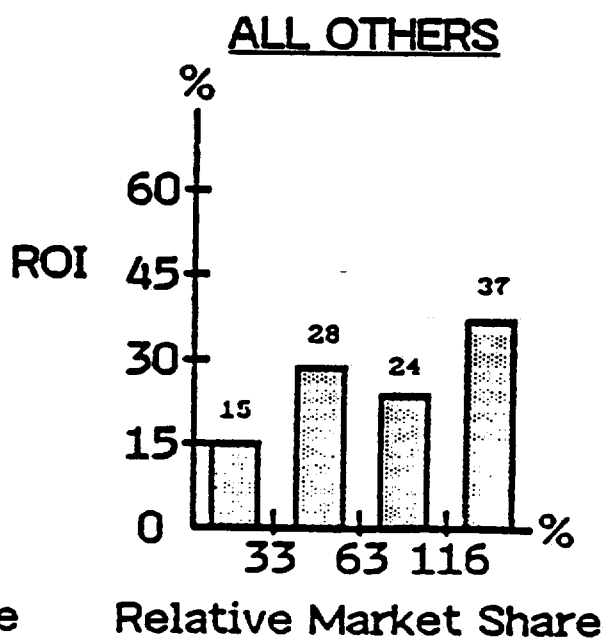
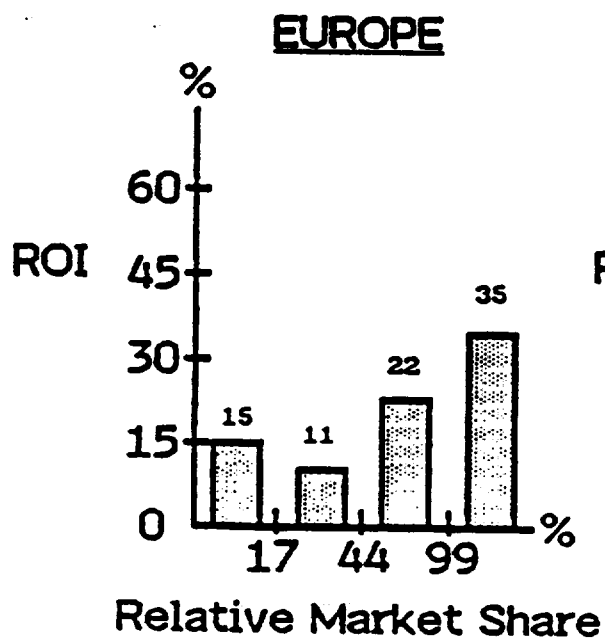
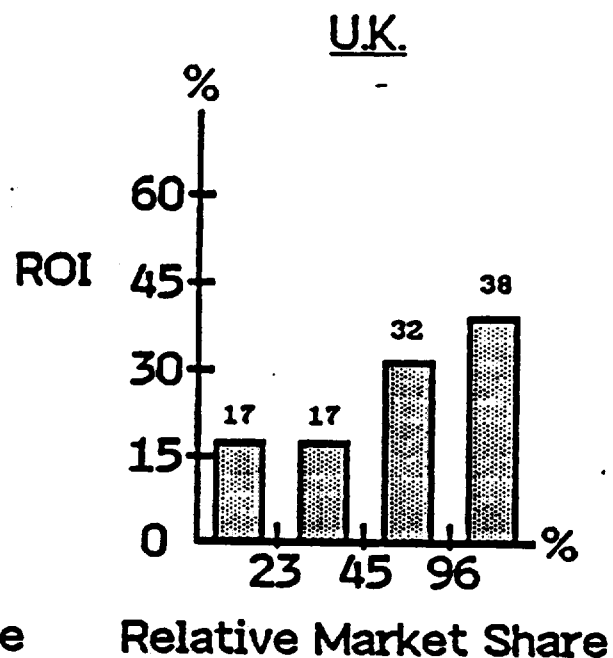
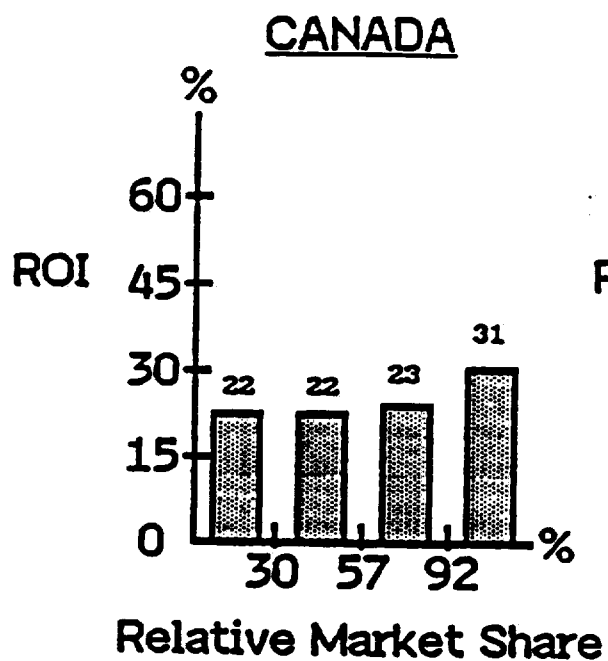


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**THE PROBABILITY OF ACHIEVING AN "ADEQUATE" RETURN
IMPROVES WITH MARKET SHARE**
% BUSINESSES WITH PRE-TAX ROI
GREATER THAN 25%



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Discussion point:

Why do you think,
market share is positively
correlated with success?

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CAPITAL STRUCTURE

KEY PROFIT DETERMINANTS

- * Investment intensity**
- * Fixed capital intensity**

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INVESTMENT =

FIXED CAPITAL (at book value)

+

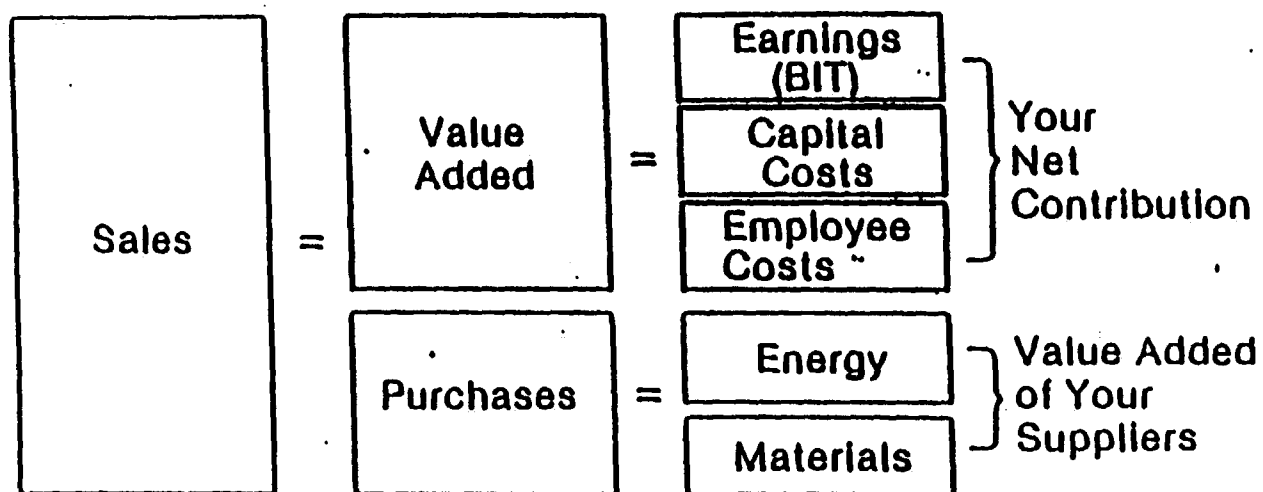
WORKING CAPITAL

Table 7-2

Value and
Sales - Purchases

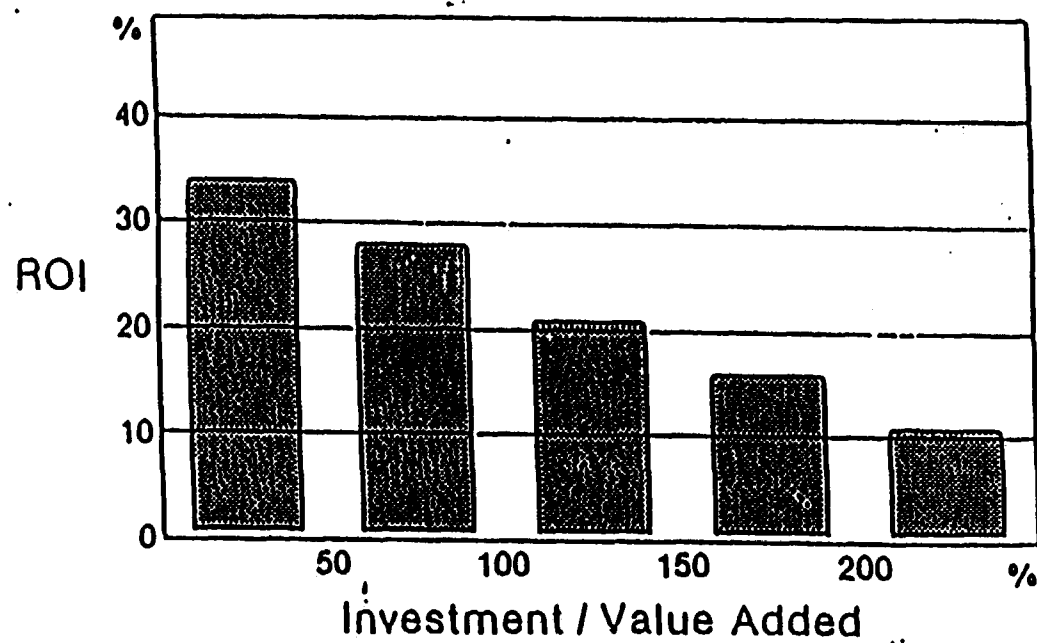
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Composition of Value Added



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Investment Intensity Is a Major Drag on Profitability



(Inv/val)

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Discussion point:

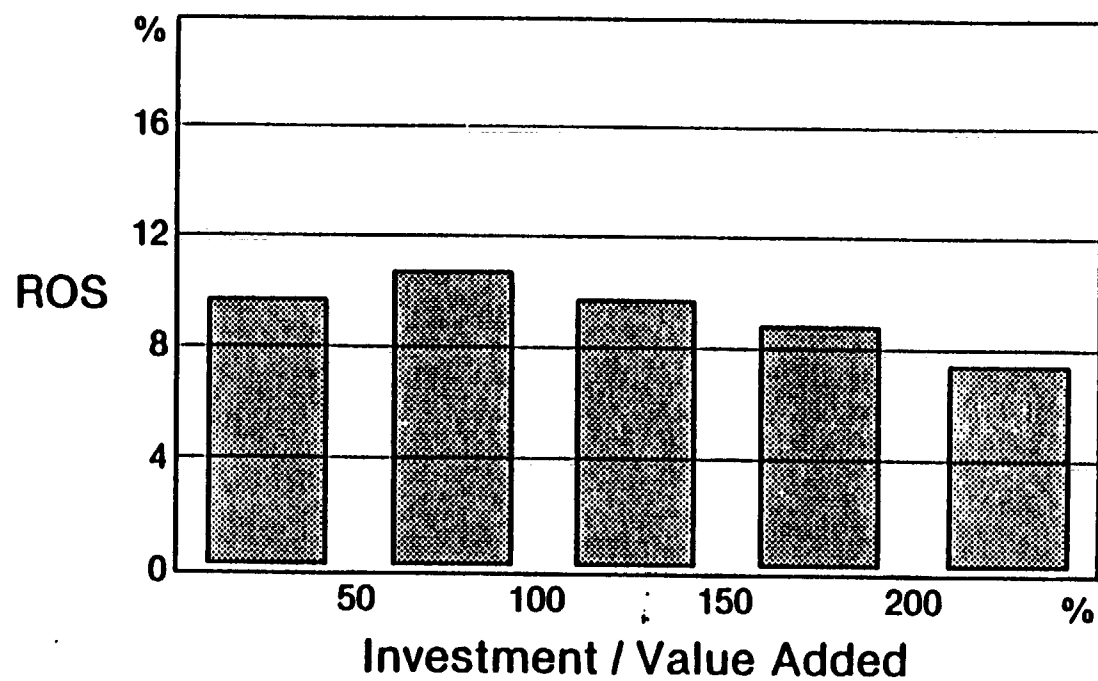
Why do you think
investment intensity
is negatively correlated
with success?

high investment
| Lower prices to customers |
| higher salary |
loss of flexibility

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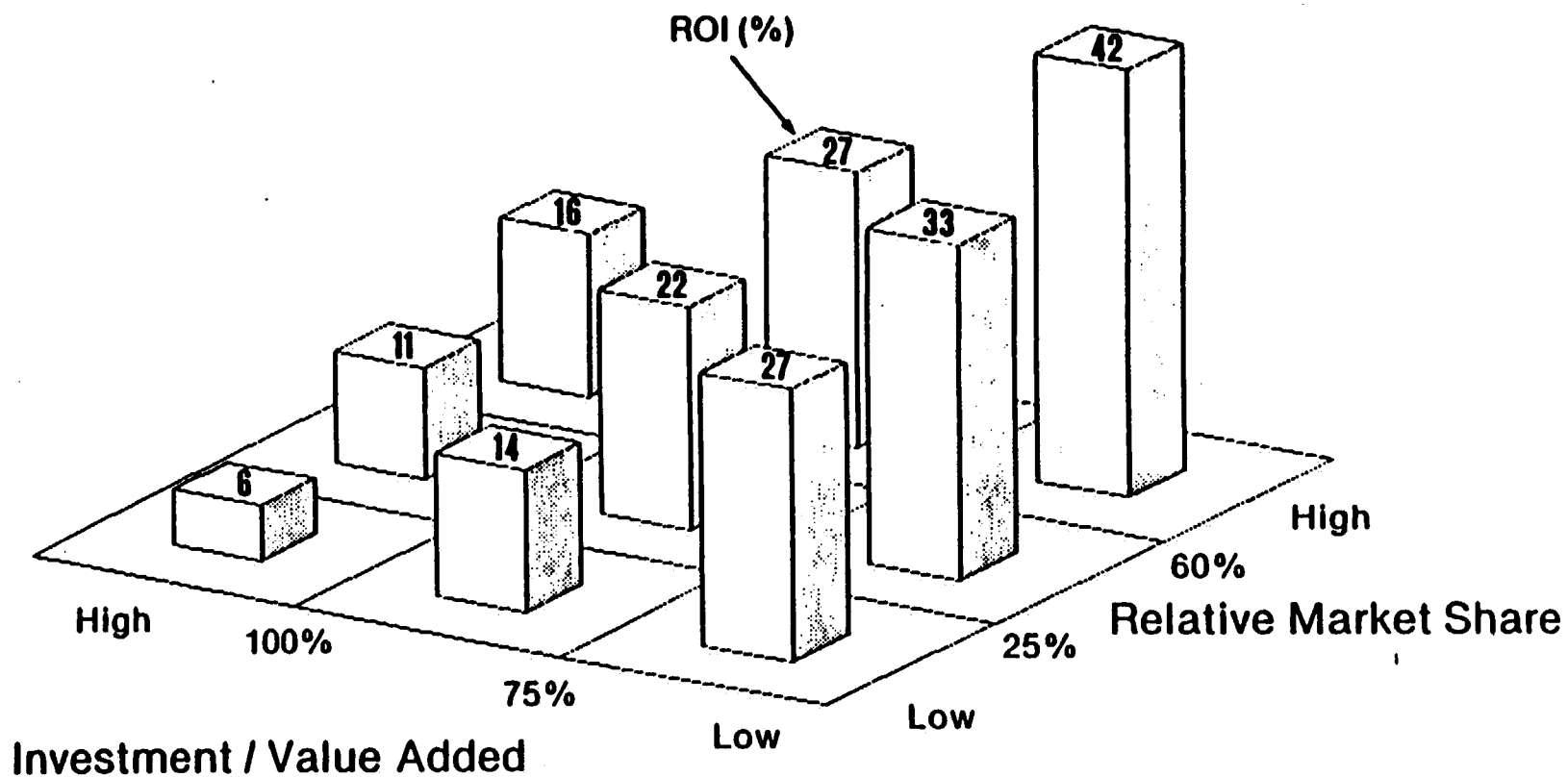
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Investment Intensity Even Squeezes Return On Sales



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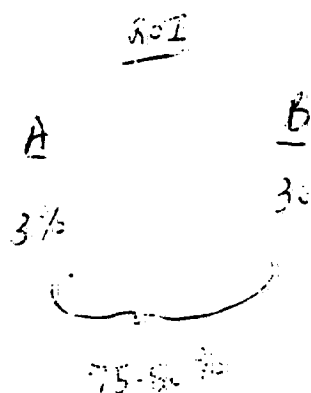
Weak Market Position and Heavy Investment Intensity Devastate Profits



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SUMMARY

- * 30+ factors jointly tell 80% of the ROI-story
- * All have been built into a 'model'
- * The model produces diagnostic appraisals on the level of a 'business'



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PIMS REPORTS ON INDIVIDUAL "BUSINESSES"

- PAR REPORT:** What profit rate and cash flow are "normal" for this combination of circumstances? Why?
- STRATEGY REPORT:** What would happen (short-term and long-term) if certain strategic changes are made?
- OPTIMUM STRATEGY REPORT:** What combination of moves would optimize a particular profit or cash criterion?

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PAR REPORT

- Normally expected performance for that kind of
 - Market environment
 - Market position
 - Production process
 - Capital/cost structure
 - Company
 - Strategic move
- Based on past performances of real businesses under comparable conditions
- Implicit assumption
 - Average managers and average "luck"

Average managers and average luck

Peak Profit

25%

10% used

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KEY FACTORS INFLUENCING ROI

| <u>FACTOR</u> | <u>EFFECT ON ROI</u> |
|----------------------------------|----------------------|
| Investment Intensity Index | (-) |
| Investment / Sales | |
| Investment / Value Added | |
| Value Added per Employee (\$000) | (+) |
| Capacity Utilization | (+) |
| Fixed Capital Intensity | (-) |
| Vertical Integration | (+) |
| Market Position | (+) |
| Market Share | |
| Relative Market Share | |
| Industry Concentration Ratio | (+) |
| Marketing Expense / Sales | (-) |
| Relative Product Quality | (+) |
| Purchase Amt-Immediate Custs | (-) |

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STRATEGY REPORT

WHAT GETS CHANGED?

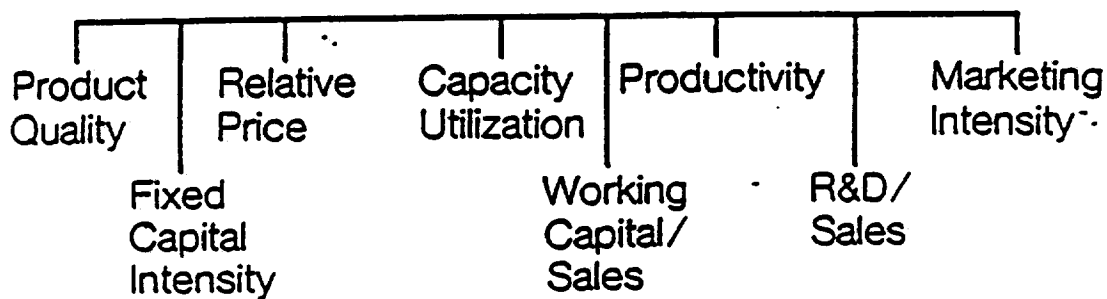
Market share

Vertical integration

Capital intensity



CONSISTENT WITH



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